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Asia Pacific Insurance Tax News

PwC's Asia Pacific Insurance Tax News is a periodic publication that offers insights into topical tax issues in the insurance industry in the Asia Pacific region.

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Contents

Editor's say

Welcome to the third edition of PwC's Asia Pacific Insurance Tax News.

In the aftermath of the global financial crisis, the wave of regulatory and accounting changes has continued unabated in the Asia Pacific. More and more countries are adopting a risk-based capital framework while at the same time adopting or laying down a roadmap for the adoption of IFRS (International Financial Reporting Standards). While all this convergence of global best practice is good for the industry, the differences in book-tax treatments have created major headaches from a tax perspective.

Tax reforms and other tax developments (both in direct taxation and indirect taxation) also continue in a number of countries in Asia Pacific with consequences to the insurance industry.

More than ever before, insurers need to keep abreast of the changing environment and proactively manage their tax risks and challenges.

In this bumper issue of Asia Pacific Insurance Tax News, our specialists from 13 countries will share with you some of these tax developments, changes and challenges. We will also share some opportunities that could be of use to you. I hope you will find our articles useful and interesting.

If you would like to discuss further any of the issues raised, please contact the individual authors or contacts listed after each article, our country leaders listed at the back of this publication or your regular contact at PwC. We look forward to your feedback.

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Australia
Tax consolidation opportunities for insurance groups

Amendments to Australia's tax consolidation rules were recently passed by the Government on 3 June 2010. Certain amendments will apply retrospectively which means they may alter previous positions taken by tax consolidated groups.

This article deals with one aspect of those amendments which may present opportunities for Australian insurance corporate groups to obtain additional tax deductions previously unavailable. Depending on the circumstances (discussed below), the tax benefit can be substantial.

What are the tax consolidation rules?

The tax consolidation rules were first introduced in 2002 and allowed Australian wholly owned corporate groups to "consolidate" for income tax purposes. This meant that members of a tax consolidated group would be treated as a single entity for income tax purposes and effectively, intra-group transactions between members of that group would be ignored. In addition, an appointed "head company" of the group, usually the parent entity, would assume all the usual income tax obligations (such as payment of tax and lodgment of income tax returns) and certain tax attributes (i.e. franking credits and tax losses) of the entire group.

On formation of the tax consolidated group (when the group first consolidated) or where an existing tax consolidated group acquires all interests of another company or tax consolidated group, the tax cost base of the assets brought into the new group is required to be reset under an allocable cost amount (ACA) calculation. Broadly, this calculation requires a "push down" of the value of shares and liabilities into the assets of the "joining" entities. In this way, there is an alignment between the price paid for the shares and the value of the assets acquired for the purposes of preventing tax arbitrage.

Prior to the new amendments, there was some uncertainty over the tax treatment of certain assets such as "rights to future income" which may be allocated a tax value under the ACA calculation, and in particular, whether any tax deductions were available. To a large extent, the position has been clarified under the new amendments.

What are the key changes?

The new changes provide that a valuable right (including a contingent right) to receive an amount for the performance of work or services, or the provision of goods (other than trading stock) will be treated as a separate asset (for the purposes described below), provided the right forms part of a contract or agreement; and the market value is greater than nil.

However, such rights exclude rights which result in the derivation of passive income that are not part of an entity's ordinary business operations (e.g. rights to income under a leasing agreement, rights to future interest, rights to an annuity and rights to royalty income).

Where a valuable right is recognised as a separate asset, tax relief is available in the form of amortisation over the lesser of 10 years or a period specified in the contract or agreement giving rise to the right provided that:

- The right is held by an entity just before it became a subsidiary member of a tax consolidated group.
- It is reasonable to expect that an amount attributable to the right will be included in assessable income after the joining time.

Timing

The new amendments apply retrospectively from 1 July 2002, being the date the tax consolidation rules first applied. However, generally, the Commissioner can only amend assessments of a company within four years from the date of the notice of assessment. Accordingly, the period for amending assessments has been extended. In addition, the amendment to prior year tax returns must be made within two years from 3 June 2010, being the date of Royal Assent.

Potential application to insurance groups

As a result of the above, there are opportunities to revisit the tax consolidation calculations previously performed by Australian insurance groups where for example, there has been an acquisition of agency companies or dealer groups which derive commission income. They may also have application to some types of insurance contracts. Obviously the amendments have a broader application to corporate groups, however, for the purposes of this article, we have confined our analysis to rights to commission income.

Some comments in relation to the relevant requirements are as follows:

1. The valuable right is a right to receive an amount for the performance of work or services, or the provision of goods (other than trading stock). For an underwriting agency and dealer groups, the relevant right is the right to receive commission income for the writing of insurance policies.

2. The valuable right forms part of a contract or agreement. This requirement should be satisfied where a right to receive commission for the provision of services was explicitly set out in a legally binding contract.

3. The market value of the valuable right is greater than nil. At the relevant time, an asset disclosed in the financial statements with value should be indicative of the market value being greater than nil.

4. The right is held by an entity just before it became a subsidiary member of a tax consolidated group. This requirement is satisfied for example, where an existing tax consolidated group acquired an agency company which prior to joining the group, held the asset being the right to income. On the other hand, the requirement is not satisfied, if the right to income "accrued" to the tax consolidated group (and therefore, nothing was paid for the rights).

5. It is reasonable to expect that an amount attributable to the right will be included in assessable income after the joining time. The relevant assessable income attributable to the right is the commission income received.

Example

Big Insurance Group (BIG), a tax consolidated group, acquires 100% of the share capital of Agency Co (AC) on 1 July 2010. Consequently AC joins BIG's tax consolidated group.

There are opportunities to revisit the tax consolidation calculations previously performed by Australian insurance groups where for example, there has been an acquisition of agency companies or dealer groups which derive commission income.

AC is a life insurance agency and receives on-going trailing commission income for policies sold through the agency under a distribution or commission contract.

The market value of the commission contract is determined to be $30,000. On joining the tax consolidated group, the tax cost setting amount allocated to the asset is $30,000.

The head company of BIG can deduct the tax costing amount for the commission agreement over a 10-year period (i.e. $3,000 each year) assuming the term of the commission contract exceeds 10 years.

If the commission agreement comes to an end in less than 10 years, the balance is deductible at that time.

Conclusion

This article is intended to provide a general overview of the new rules and therefore, should not be relied upon without seeking specific advice. Depending on the circumstances of each case, further due diligence should be conducted to confirm whether any tax benefits are available. In addition, tax advice on the application of the changes to your particular circumstances should be obtained.

In this regard, there are some steps set out below which can be taken, in conjunction with your PwC tax adviser.

- Revisit past tax consolidation calculations in relation to the formation of a tax consolidated group and subsequent acquisitions.
- Identify asset eligibility.
- Gather information regarding the value of the asset (including contractual arrangements).
- Assess the life of the asset.
- Assess the market value of the asset.
- Consider lodging a private ruling request with the Australian Taxation Office to ensure certainty of treatment.
- Lodge amendments to prior years' income tax return.
- Consider any other implications (e.g. accounting).

Taxpayers should act swiftly as given the two-year time-frame, there is only a limited window of opportunity available!

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China

Tax challenges ahead for foreign insurers

2010 is proving to be a year of unprecedented changes for foreign insurance companies in China. A number of Japanese and Korean insurers have entered the market while several other foreign insurers have announced plans to reorganise their joint ventures in China.

In the post-financial crisis era, many foreign insurers are taking a fresh look at their China business models and re-strategising their positions.

This article highlights some of the latest developments in the China tax and regulatory regimes that may affect foreign insurers operating in the fast-growing China market.

Taxation changes arising from new China accounting standards

In 2009, China unveiled changes to its accounting standards for insurers that would alter how they account for income, actuarial reserves and acquisition costs. The move was intended to bring the China accounting standards closer to international accounting practice.

The new accounting rules set a new standard for calculating provisions, which essentially helped many insurers reduce their reserves thus improving their profitability in China.

Foreign insurers with significant tax loss brought forward should welcome the new rules as it allows them to become more profitable, so as to have a better chance of utilising their tax losses before the five-year expiry period.

Insurers that adopted the new China accounting standards from 2009 were also required to adjust their opening reserve retrospectively. Such retrospective adjustment should not hit the insurers' current year accounting profit but would directly contribute to their retained earnings.

The Chinese tax authorities have not issued guidelines on whether such retrospective adjustment to retain profits in 2009 should be subject to corporate income tax and if so, how that amount would be taxed. This has become a significant uncertain tax position faced by the insurers in China. In this connection, some local tax authorities have not taxed the retrospective retained profits adjustment when they assessed the insurers' 2009 annual tax filing. There is clearly a risk that the Chinese tax authorities may subsequently "back-tax" the 2009 retrospective retained profits adjustment. In anticipation of this potential exposure, insurers need to review their deferred tax provisions on this issue.

Unfavourable new tax deduction cap for agency commission

Recently, the Chinese tax authorities revised the basis for insurers to claim tax deduction for agency commissions. For life insurers, the new basis capped deductions for agency commission to 10% of the insurer's related current year premium income. In contrast, the old tax rule only allows a lower 5% tax deduction cap based on the total premium to be earned over the whole term of the life policy.

Insurers having a product mix focusing on single-premium policies generally welcome the new tax deduction basis

Insurers with long term regular-premium policies may face significant difficulties with the new tax deduction cap for commissions.

given the tax deduction cap have been raised from 5% to 10%.

On the other hand, insurers writing or intending to write long term regular-premium policies may face significant difficulties with the new tax deduction cap as, typically, the ratio of first year agency commission to first year premium income for such policies is far higher than the 10% tax deduction cap. This tax inefficiency for regular-premium products may cause insurers to gradually shift their product mix towards single-premium products.

Meanwhile, the Chinese Insurance Regulatory Commission (CIRC) has issued a policy directive encouraging insurers to write more regular-premium products which can offer more stability to the insurers' business revenue than that from single-premium products. However, with the new tax deduction rules in mind, insurers in China appear to be in a dilemma between adopting a tax efficient product mix and being supportive of CIRC's policy directive.

Cross-border transactions

As foreign insurers' activities in China have become more sophisticated and profitable, cross-border transactions have become an emerging tax issue for foreign insurers. Typical insurers' cross-border transactions may include:

- Reinsurance or retrocession premiums paid overseas from China.
- Head office expense allocation or services charges from overseas affiliates.

Special regulatory approval may be required for insurers to effect cross-border payments. In addition, withholding tax and business tax may also arise on these cross-border transactions. In a situation where the charges are made to related parties, they would be subject to close scrutiny by the Chinese tax authorities with a view to avoiding tax leakage.

Insurers making cross-border payments should develop proper tax withholding procedures and maintain robust transfer pricing documentation in anticipation of the Chinese tax authorities' extensive queries on this issue.

Upcoming value added tax (VAT) reform

Insurers in China are currently not required to pay VAT because they are subject to a separate insurance premium tax known as business tax (BT), which is charged at 5% on the gross insurance premium earned.

Life insurers are generally in a more tax advantageous position as life products can be granted an exemption from BT upon proper approval by the Chinese tax authorities. However, the existing BT regime has been seen by the Chinese government as not being compatible with the Chinese VAT system and there is a proposal to reform VAT for the financial services industry, including the insurance sector. The Ministry of Finance & a special working group under the People's Congress are in the midst of preparing the new draft on VAT law for consultation and legislative purposes.

Chinese insurers are concerned over the upcoming VAT reform and some of the more common questions being asked are:

- Will the new VAT regime allow life insurers to continue enjoying the preferential insurance premium tax exemption under the old BT system?
- Will the upcoming VAT reform offer non-life insurers new preferential insurance premium tax treatment?
- If, in the worst case scenario that the Chinese government does not allow VAT exemption for the insurance sector in future, what would the future VAT rate applicable to insurers be?
- In the event that the Chinese government offers VAT exemption to insurers, can the insurers recover the input VAT credit paid on purchases?

Insurers in China may need to address and channel their concerns on the prospective VAT reforms to the Chinese law makers through industry lobby groups.

Know-how transfer and cooperation with domestic insurers

China permits foreign insurers to buy a minority stake in domestic insurance companies to enhance know-how transfer and cooperation amongst domestic and foreign insurers.

To further achieve know-how sharing and co-operation, it has become a common practice for foreign insurers to enter into technical cooperation agreements with domestic insurers. Overseas insurance specialists fly regularly into China to support the domestic insurers' operations under these agreements. Many of them are temporary visitors who may work on the domestic insurers' internal projects, such as upgrading management systems, building IT systems, staff training, etc.

Under most double taxation treaties that China had signed with its foreign treaty partners, when an overseas insurance company sends employees to China to perform services, such an overseas company may not have a risk of taxable presence in China unless such activities continue for the same or a series of connected projects for a period or periods aggregating more than six months within any 12-month period.

The issue of service permanent establishment (PE) exposure for overseas companies arising from their employees visiting China has become a particularly hot topic in China, because of Tax Ruling No. 403 which was issued in April 2007. Under this Ruling, the counting of days for the purpose of this six-month taxable presence test in China has been adversely interpreted by the Chinese tax authorities.

For the purpose of determining a service PE, Tax Ruling No. 403 provided that the "six-month" period should start from the first time an employee of an overseas company enters China to perform services, to the time the employee is present in China for the same or connected projects, regardless of the number of days that the employee actually spends in China during any calendar month. During this period, however, for each consecutive 30 days that the overseas company does not have an employee in China to perform services for the project or connected projects, one month will be deducted from the total number of months. If by using this method of counting, the total number of months exceeds six months in any 12-month period, the overseas company will be deemed to have a PE in China. Under this method, one day can equal one month, and thus it is possible that seven months of just one day of presence could theoretically create a service PE.

This "one day equals one month" method has caused widespread concern amongst the foreign financial service sector in China. Some countries like Hong Kong and Singapore have resolved this issue by changing the term "six months" to "183 days" in their double tax treaties with China. However, this still remains a potential issue for other tax treaties that use the term "six months".

Expatriate secondment taxation

"People are our most important asset" is a commonplace expression that goes back a long way. Foreign insurers have been relocating their best talent to China to implement their expansion and business plans. As a result, more complicated expatriate relocation issues have emerged in this market.

Whilst the compensation and benefit structure of expatriates assigned to China needs to be carefully designed to meet various human resources (HR) objectives, the taxation arrangement of these expatriates also needs to be closely monitored to ensure their tax efficiency. The existing Chinese individual tax rules are in a state of flux. It is not uncommon to discover that a HR department has followed outdated Chinese tax planning ideas to develop compensation packages for their China assignees. Common misconceptions include the following:

- that dual employment contracts allow income from offshore contracts to escape taxation in China;

- that expatriate income not borne by the China entity is excluded from taxation in China;

China's premium growth projections continue to look very buoyant. While opportunities and optimism may abound, foreign insurers must not forget their tax costs. There is a need to take a hard look at their future tax strategies to ensure tax efficiency.

- that all staff reimbursements are tax free;
- that the "tax on tax" effect (where the employer pays the employee's China tax liability) is ignored in the China tax computation.

Failure to update the tax plan for expatriate packages and the resulting cost of tax adjustments, penalties and late payment surcharges on inappropriate expatriate tax plans in China can be prohibitive.

In 2009, many Chinese local tax authorities launched special tax audits targeting foreign companies (including foreign insurers) that second expatriates to work in their Chinese affiliates.

Some Chinese local tax authorities have also taken an aggressive position that expatriate secondment to China can create a Chinese PE for the overseas companies that seconded the employees. They would then seek to impose a 5% business tax and a 25% corporate income tax on the secondment charges paid from China to the overseas companies. It is anticipated that expatriate secondment costs will increasingly come under tax attack. Foreign insurers should review their existing secondment arrangements to assess their potential exposure.

The way forward

The new China accounting standards represent a sea of changes in the marketplace to enable foreign insurers to deliver a healthier bottom line in the future. More positive regulatory changes are anticipated including the opening up of the auto-insurance market to foreign players. Meanwhile, China's premium growth projections continue to look very buoyant. While opportunities and optimism may abound, foreign insurers must not forget their tax costs. There is a need to take a hard look at their future tax strategies to ensure tax efficiency for their China operations.

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China

Observations on transfer pricing for insurers operating in China

The growth of China's domestic insurance companies and their expansion overseas; the increasing scale, scope and reach of foreign insurers in China; and the expansion of transfer pricing around the world and in China under the 2008 Corporate Income Tax (CIT) Law mean that transfer pricing is increasingly an issue for foreign insurers operating in China and for Chinese domestic insurers operating overseas.

Transfer pricing compliance rules

Transfer pricing rules in China, in place for nearly 20 years, were greatly increased by the introduction of the CIT Law in 2008 and the expanded rules, regulations and guidance that China's State Administration of Taxes (SAT) has dedicated to the subject through this and subsequent publications.

The arm's length principle acts as the governing principle for transfer pricing in China. Taxpayers are required to use a transfer pricing method to demonstrate that their related party transactions have been priced in accordance with this principle.

As well as ensuring that all related party transactions comply with the arm's length principle, China's tax law imposes certain obligations on taxpayers with related party transactions:

- **Related party transaction (RPT) forms** – Taxpayers are required to file nine RPT Forms as part of their CIT return package.

- **Documentation** – Chinese taxpayers with total related party transactions in excess of RMB40 million per year (for insurance companies) are required to prepare, maintain and, upon request of the tax authorities, submit contemporaneous documentation regarding their related-party transactions.

- **Loss makers** – According to the SAT, entities with 'limited functions and risks' should in principle not bear losses. Where such entities do incur losses they are required to prepare transfer pricing documentation regardless of whether their related party transactions have exceeded the RMB40 million threshold and submit it automatically i.e. without waiting for a request from the tax authorities.

In recent months, the tax authorities in China have begun a process of collecting, reviewing and assessing the transfer pricing documentation prepared by taxpayers. The financial services sector is being examined in more detail than most.

Increasing issue for insurers

Transfer pricing is increasingly an issue for insurance companies operating in Mainland China not only because of the legislative and environmental changes outlined above but also because the scale and scope of their related party transactions are increasing.

In many cases the increasing importance of transfer pricing for insurers operating in Mainland China is primarily a result of one of the following two developments:

In China, at the moment, many subsidiaries and branches of overseas financial services companies are not charged for the support services they receive because the extra costs could cause them to incur losses or because they have not received tax or regulatory approval to pay the fees.

- **Increasing levels of related party reinsurance** – As foreign groups begin to be allowed to engage in reinsurance transactions to manage their risks in China, the scale of these transactions often cause them to breach China's transfer pricing documentation preparation threshold.
- **Increasing levels of support** – As foreign groups' local insurance operations in China grow, they frequently require more support from their overseas shareholders or their local joint venture partners.

Domestic groups are also beginning to engage in related party transactions that may require them to prepare transfer pricing documentation in China and may now be transacting with affiliates in overseas jurisdictions that have their own transfer pricing regimes.

Key issues

The types of related party transactions that the insurance companies operating in China typically have to price include the following:

- reinsurance transactions;
- services and support; and
- asset management.

Reinsurance transactions

In China, insurance companies engage in many types of reinsurance with their related parties, whilst frequently also engaging in similar transactions with third parties.

Although related party reinsurance transactions are typically reviewed and approved by the Chinese Insurance Regulatory Commission, China's tax law requires that the taxpayer consider the pricing of the transactions from a transfer pricing standpoint and demonstrate that the transactions have not resulted in the taxpayer achieving less than an arm's length profit from the transactions under review.

Often, transfer pricing documentation of reinsurance transactions, as well as detailing the nature of the transactions themselves, supports the pricing that has been applied by using the Comparable Uncontrolled Price (CUP) method.

Services and Support

Most multinational groups have regional hubs or head offices providing support and assistance to their Chinese subsidiaries or joint ventures. Many multinational groups have global policies determining their pricing of support services and head office support and in many cases there is also global transfer pricing documentation describing the pricing mechanism.

In China at the moment, however, many subsidiaries and branches of overseas financial services companies are not charged for the support services they receive because the extra costs could cause them to incur losses or because they have not received tax or regulatory approval to pay the fees. Where this is the case and there is no charge, transfer pricing and cost deductibility must be considered in the country of the service provider, as the local transfer pricing rules may require it to impute a service fee or restrict it from deducting the costs relating to the China entity.

On the other hand, where significant support service fees are indeed charged to a Chinese entity or joint venture, it is important that specific Chinese transfer pricing documentation is compiled to support the service fee since this is often one of the biggest intra-group transactions for financial services entities in China and an easy transaction for the tax authorities to challenge or disregard. In most cases, transactions of this type in China are priced using the Transactional Net Margin Method (TNMM) (utilising a mark-up on full costs) or they are charged using an allocation of costs with no mark-up.

Asset Management

Investment income is an important source of revenue for insurance companies and asset management is a specialist function that is often, internationally at least, managed separately from the day-to-day insurance activities that all groups must perform. Outside of China, this separation gives rise to related party asset management transactions as specialist group companies invest the reserves and capital of their insurance company affiliates.

Asset management focused related party transactions are not yet an issue for foreign insurers operating in China since they do not engage overseas asset management affiliates to manage their assets. Asset management related party transactions are, however, becoming relevant for the largest outbound domestic insurance companies as they begin to expand overseas by establishing asset management operations in Hong Kong.

There is a wealth of external data on the fund management fees that asset managers charge for managing different types of investment strategy in different areas of the world and this data, together with internal data from the taxpayers' own business, often provides the basis for setting the transfer pricing for asset management related party transactions.

Conclusions and recommendations

Transfer pricing is becoming an increasingly important, yet complex, issue for insurance companies operating in China and should not be ignored. Our key recommendations for insurance companies operating in China are:

1. examine your related party transactions and focus on the largest transactions with the most tax at stake;

2. confirm that your transfer pricing complies with the arm's length standard;

3. consider whether you are obliged to prepare transfer pricing documentation; and

4. prepare transfer pricing documentation if required.

We also recommend that insurers seek professional assistance as the issues are typically more complex than it appears.

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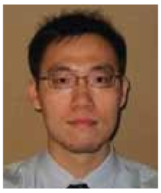

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Hong Kong

Tax treaty development – How would it help insurers operating in Hong Kong?

The Hong Kong Inland Revenue Ordinance was amended in early 2010 to enable Hong Kong to adopt in its tax treaties the more liberal 2004 version of the Exchange of Information article endorsed by the Organisation for Economic Co-operation and Development. With the removal of this major stumbling block to negotiating and concluding treaties with other countries, the Hong Kong Government has been proceeding quickly in expanding Hong Kong's tax treaty network over the last few months.

As at October 2010, Hong Kong has signed 14 comprehensive double taxation agreements (DTAs) with Belgium, Luxembourg, Mainland China, Thailand, Vietnam, Brunei, Indonesia, the Netherlands, Austria, Hungary, Ireland, Kuwait, the United Kingdom and Liechtenstein. Of these, the nine DTAs signed by Hong Kong in 2010 with Brunei, Indonesia, the Netherlands, Austria, Hungary, Ireland, Kuwait, the United Kingdom and Liechtenstein are subject to ratification and are not yet in force.

Other DTAs which are currently under negotiation include those with France, Japan, Switzerland, Malaysia, United Arab Emirates, Saudi Arabia, Finland, India, Czech Republic, Italy, Denmark, Macau and Spain.

What does this new development mean for insurance companies operating in Hong Kong? How would the insurance industry benefit from Hong Kong's expanding tax treaty network? We summarise below some of our high level thoughts.

Enhanced investment returns

DTAs normally reduce, or even eliminate, withholding tax (WHT) rates on passive income (e.g. interests, dividends, capital gains, etc) earned by one treaty party from the country of the other party. With the expanded treaty network, Hong Kong insurance companies investing in equities and debt securities of issuers resident in countries with which Hong Kong has a DTA can now enjoy lower overseas withholding taxes on interests, dividends and capital gains derived from these investments, effectively enhancing the returns from these investments.

> *With the expanded treaty network, Hong Kong insurance companies investing in equities and debt securities of issuers resident in countries with which Hong Kong has a DTA can now enjoy lower overseas withholding taxes.*

For example, Hong Kong insurance companies can now enjoy a reduced Chinese WHT rate of 7% (vs 10% when there was no China-Hong Kong DTA) on interest income if they invest in debt securities of Chinese issuers. In addition, a gain on disposal of Thai equities can now be exempt from 10% Thai WHT under the Hong Kong–Thailand DTA. Interest earned by Hong Kong insurance companies from certain debt instruments issued by UK issuers may now also be exempt from the 20% UK WHT.

Regional holding company location

Hong Kong has either concluded or commenced negotiations of tax treaties with many Asian countries. Please refer to Table 1 for a list of the Asian countries and the status of Hong Kong's treaty negotiation.

With a widening network of treaties in Asia, Hong Kong can be an ideal location, from a tax perspective, for multinational insurance groups to establish an Asian holding company for their Asian businesses to facilitate better capital management within Asia and/or to align the legal structure with the regional management structure.

Under the DTAs that Hong Kong has concluded, the Hong Kong Asian holding company can enjoy reduced local WHT rates on dividends received from its Asian subsidiaries (see Table 2). Together with the advantage that Hong Kong does not tax dividend income received from overseas subsidiaries and does not impose WHT on further dividend payment to an overseas parent company, using Hong Kong as the location for an Asian holding company can achieve tax efficient dividend repatriation from Asia.

In addition, as Hong Kong has concluded (and commenced to negotiate) tax treaties with a large number of European countries (see Table 3), Hong Kong can also be an ideal location through which Asian (including Chinese) insurance groups can expand their footprint into Europe. Most of Hong Kong's treaties with its European treaty partners offer favourable reduced rates on dividend payment (see Table 2).

Table 1 – Status of DTAs concluded/negotiated with Asian countries

Asian countries that have concluded DTA with HK	Asian countries under DTA negotiation with HK	Asian countries that HK has not commenced DTA negotiations
Mainland China	Japan	Korea
Thailand	India	Singapore
Vietnam	Malaysia	Taiwan
Brunei	Pakistan	The Philippines
Indonesia	Macau	

Table 2 – Summary of dividend WHT under Hong Kong's tax treaties

	WHT rate under domestic law	WHT rate under HK's DTAs (more conditions req'd for lower rate to apply)
Asia		
China	10%	5% / 10%
Vietnam	Nil	Nil
Brunei	Nil	Nil
Thailand	10%	10%
Indonesia	20%	5% / 10%
Europe		
Belgium	25%	0 / 5% / 15%
Luxembourg	15%	0 / 10%
The Netherlands	15%	0 / 10%
Austria	25%	0 / 10%
Hungary	25%	5% / 10%
Ireland	20%	0
UK	0/20%	0 / 15%
Liechtenstein	4%	0

Table 3 – Status of DTAs concluded/negotiated with European countries

European countries that have concluded DTA with HK	European countries under DTA negotiation with HK
Belgium, Luxembourg, The Netherlands, Austria, Hungary, Ireland, United Kingdom, Liechtenstein	France, Switzerland, Finland, Czech Republic, Italy, Spain, Denmark

Regional headquarters

With competitive advantages such as having a quality workforce, a well-developed infrastructure, proximity to all Asian jurisdictions and being one of the freest economies in the world, Hong Kong is always one of the preferred locations for multinational insurance groups to set up their regional headquarters in Asia. The escalating list of tax treaties that Hong Kong is concluding is further reinforcing Hong Kong's position as such a preferred regional headquarter location.

One of the benefits that tax treaties offer is to protect the regional headquarters from creating an inadvertent permanent establishment (PE) in different Asian countries as a result of its executives visiting, or rendering services in, these countries for a short period of time. Consequences of having such inadvertent PE can be very burdensome, both financially (e.g. the PE may have to pay local corporate income tax, and the travelling executives may have to pay local individual income tax) and administratively (e.g. the PE may have to fulfil local tax reporting and filing obligations).

All the tax treaties that Hong Kong has concluded with its Asian treaty partners provide that a "service PE" will only be created in these jurisdictions if the employees of the Hong Kong entity provide services (for the same or connected projects) in these jurisdictions for a period of more than 183 days (or 6 months) within any twelve-month period. In other words, if the travelling executives of the Hong Kong regional headquarters perform services, on an occasional basis, for its other group companies in the jurisdictions which have concluded tax treaties with Hong Kong, the risk of the Hong Kong regional headquarters creating an inadvertent PE in those jurisdictions is much reduced.

Reinsurance hub

In the past, when reinsurance premiums are received by a Hong Kong reinsurer from accepting offshore insurance risks, local withholding taxes may be levied at source by certain Asian locations. This disadvantage has been removed in some of the DTAs that Hong Kong has concluded. Specifically, under the DTAs that Hong Kong has concluded with Indonesia and Vietnam, reinsurance premiums paid by local Indonesian and Vietnamese insurance companies for ceding out insurance risks to a Hong Kong reinsurer are exempt from local withholding taxes.

Together with the tax incentive that Hong Kong offers to professional reinsurers (that offshore non-life business is only taxed at 50% of the normal profits tax rate, i.e. at 8.25% currently), Hong Kong now has the competitive advantage, from a tax perspective, to become a reinsurance hub in Asia. Multinational insurance groups can also consider setting up their regional reinsurance centre in Hong Kong for capital management purposes.

Final remarks

Hong Kong has all along been renowned for its simple, low and predictable tax regime. This is also believed to be one of the factors contributing to the success of the Hong Kong insurance industry in Asia. With the expansion of the tax treaty network, Hong Kong would undoubtedly gain a further competitive advantage in the region. It is now time for the industry to identify the opportunities and take advantage of the benefits brought by this new development.

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India

New Direct Taxes Code, 2010 – Revised proposals affecting the insurance sector

In August 2009, the draft Direct Taxes Code, 2009 (the 'DTC 2009') was released by the Indian Government proposing to replace the existing income-tax law with effect from 1 April 2011.

Based on representations made by various stakeholders (including insurance companies), certain major issues were addressed in a Revised Discussion Paper (the 'RDP') released on 16 June 2010 for public comments.

Recently, on 30 August 2010, the Government released the Direct Taxes Code Bill, 2010 (the 'DTC 2010') taking into account the representations made on the proposals contained in the DTC 2009 and the RDP. The DTC 2010 is now proposed to be effective from 1 April 2012 and not 1 April 2011 as originally proposed in the DTC 2009.

The key points of the DTC 2010 for the insurance sector are discussed in this article below.

Taxable income and tax rates

Life insurance

The DTC 2010 has retained the original proposal to tax the profits of the Shareholders' account and treat life insurance companies as "pass through" entities in so far as the profits in the Policyholders' account are concerned. Thus, income of the Policyholders' account is no longer taxable at the life insurance company level.

The profits in the Shareholders' account (i.e. Non-Technical account) are subjected to certain adjustments and such adjusted profits are then taxable at the general corporate tax rate of 30%. The earlier proposal in the DTC 2009 to reduce the corporate tax rate to 25% no longer applies.

The above proposals are significantly different from the present scheme of taxation under which profit from life insurance business is taxed at a special rate of 12.5% as against the existing general corporate tax rate of 30%. With regards to what constitutes profit from life insurance business, there is a prolonged controversy under the current tax regime as to whether income from both Shareholders' account and Policyholders' account represent profits from life insurance business and therefore, whether income from the Shareholders' account is also subject to tax at the special rate of 12.5% as against the general corporate tax rate of 30%.

Non-life insurance

The DTC 2010 proposes to treat the profits disclosed in the annual accounts of non-life insurance companies, subject to certain prescribed adjustments, as the taxable profits from non-life insurance business.

This proposed basis of taxation is broadly in line with the current taxation regime. In addition, the tax rate applicable is the current general corporate tax rate of 30%. The reduced tax rate of 25% originally proposed in the DTC 2009 no longer applies.

In spite of recommendations and feedback given, the DTC 2010 (as with the DTC 2009) does not categorically address the issue of carry forward of losses incurred prior to the introduction of the DTC 2010.

Minimum Alternative Tax (MAT)

The current tax regime provides for MAT to be levied at the rate of 18% on the book profits (subject to certain specified adjustments) of the company. MAT is payable only when the normal tax liability of the company is lower than the MAT so calculated.

The DTC 2009 had proposed to change the basis of levy of MAT from 'book profits' to 'gross assets'. Much to the relief of the insurance companies, the DTC 2010 proposes to continue with the 'book profit' based MAT as prevailing under the current tax regime but at a slightly higher rate of 20%.

The credit for MAT is allowed to be carried forward for set off against the company's normal tax liability for up to fifteen years. This is an improvement when compared against the ten years carry-forward currently available under the existing tax law.

Grandfathering provisions and carry forward of losses

Currently, business losses are allowed to be carried forward for a period of eight years. The DTC 2010 proposes to allow the carry forward of such losses for an indefinite period, as originally proposed in DTC 2009.

However, in spite of recommendations and feedback given, the DTC 2010 (as with the DTC 2009) does not categorically address the issue of carry forward of losses incurred prior to the introduction of the DTC 2010.

Dividend Distribution Tax (DDT)

Under the DTC 2010, it is proposed that dividends paid to an insurance company will suffer DDT, a proposal which is in line with the present law. The DDT rate proposed is 15% as against the effective tax rate of 16.61% under the present law.

Non-life insurers – deduction for unascertained liabilities

The DTC 2010 has considered one of the recommendations of the non-life insurance industry by providing a specific deduction for amounts transferred to unexpired risk reserve. However, the issue of deduction of other statutory provisions like Incurred but not reported provisions (IBNR), Incurred but not enough reported provisions (IBNER) and Premium Deficiency reserves remain unsolved under both the current tax regime as well as under the DTC.

Non-life insurers– profit on sale of investments

Non-life insurance companies usually hold investments for the long term to meet mandated obligations for investments in infrastructure and social sectors and also to meet asset-liability matching requirements. As presently worded in the DTC 2010 provisions, these companies would not get the benefit of indexation of the cost of acquisition of the investments and will therefore lose on the time value of money.

Furthermore, the current tax regime specifically provides that unrealised losses on investments are not deductible and unrealised profits are not to be taxed. In the absence of any specific provision in the DTC 2010, the unrealised gains on investments could be taxed under the DTC.

Tax levy on income distributed by life insurers to policyholders

The DTC 2010 proposes a new levy of tax at the rate of 5% on the income distributed/paid by a life insurance company to its policyholders of an "approved equity oriented life insurance scheme". An "approved equity oriented life insurance scheme" is a scheme where, subject to other conditions, more than 65% of total premiums received by the life insurance company are invested by way of equity shares in domestic companies.

It is also proposed that no deduction be allowed nor any tax credit be available to the life insurance company concerned for taxes paid on such distributed income.

Tax Withholding on certain life insurance policies

The DTC 2010 proposes to lay down a new requirement to withhold tax (at the rate of 10% in case of individuals/Hindu Undivided Families and 20% in other cases) from payments made by life insurance companies under a life insurance policy except in certain specified cases where such income is not chargeable to tax. The current tax regime does not require any withholding tax from such payments.

Life insurance policyholder level tax – shift from EEE regime

The DTC 2010 proposes to do away with the current "EEE" (Exempt- Exempt-Exempt) regime. EEE is a regime under which there is no tax incidence at any of the three stages under a life insurance policy i.e. First E - contribution stage, Second E – accumulation/accrual of income stage and Third E – maturity of policy stage. The Third E only applies when certain conditions are satisfied.

First E – Contribution stage

The DTC 2010 provides for an aggregate deduction of up to INR 50,000 for payments made towards life insurance, health insurance and tuition fees. Currently, life insurance premium payments are deductible up to an aggregate amount of INR 100,000 along with certain other payments covered within such deduction limit.

Second E – Accretion stage

The language of the DTC 2010 suggests that it is not only the sums received but even the sums receivable under a life insurance policy which would be taxable on policyholders. The current tax regime provides for taxability (if any) of insurance proceeds only on a receipt basis.

If policyholders were to be taxable at the income accretion stage of a policy there will be far reaching implications for life insurance companies and its policyholders. Not only will there be practical difficulties in determining the exact sum that would be taxable, there would also be procedural difficulties complying with the new withholding tax provisions for insurance companies.

Third E – Maturity stage

The DTC 2010 proposes to treat the sums received as taxable under the heading 'Income from Residuary Sources' whereas under the current tax regime, sums received under a life insurance policy are not included in taxable income (subject to fulfilment of certain conditions) and accordingly, not chargeable to tax. Thus, there is a radical shift in the basis of taxation of sums received from a life insurance company.

The DTC 2010, however, proposes certain relaxations by providing for tax exemption in the case of sums received on death and by providing for deduction of sums, if the same are received under a policy where the premiums paid in any of the years during the policy term do not exceed 5% of the capital sum assured. Under the current tax regime, the tax exemption is subject to a more relaxed criteria of 20%. The DTC 2010 also provides for deduction of the sums received under an equity oriented life insurance scheme where tax has been

The DTC 2010 proposes to do away with the current "EEE" regime.

paid by the life insurance company on the income distributed/paid.

The stringent condition of a 5% cap as compared with the present cap of 20% is likely to have a considerable impact on the sector.

Please refer to the table below for a comparison of the current EEE regime and the new regime under DTC 2010.

Grandfathering of existing policies

Life insurance products under the current tax regime generally enjoy an EEE basis of taxation. The DTC 2010 proposes to do away with the EEE regime, in which case it is expected that policies issued prior to the DTC would be grandfathered. However, the DTC 2010 does not contain any such provision, although in the RDP, it was proposed by the Ministry that policies issued prior to the DTC becoming effective would be grandfathered.

Withholding tax on insurance premiums earned by a non-resident

The DTC 2010 has introduced a deeming provision whereby any person who collects premiums in India or insures risks situated in India by acting on behalf of a non-resident who is engaged in the business of insurance would constitute a permanent establishment of a non-resident in India.

Under DTC 2010, insurance/reinsurance premiums payable for covering any risk in India is deemed to be income accruing in India. It is also proposed that insurance/reinsurance premiums payable to a non-resident would be liable to withholding tax at the rate of 20%.

While the treaty protection, if any, should be available, the above provision does create a tax exposure for foreign insurance companies, especially reinsurance companies doing business in India.

In addition, the above provision has far reaching implications in cases where any premium payable under a global arrangement by one non-resident entity

A comparison of the current EEE regime and the new regime under DTC 2010

	Current EEE regime	DTC 2010 regime
Contributions by policyholder (P/H) or investment into policy	Deduction of up to INR100,000 together with some other payments, allowed from total income liable to tax	Deduction of up to INR50,000 towards life insurance, health insurance and tuition fees, allowed from total income liable to tax
Accretion of investment income on policy	No taxation to P/H	DTC language suggests P/H taxation arises at this stage. However, DTC provides for withholding tax (WHT) obligation at the time of payment and not on accretions
Maturity of policy	Insurer has no WHT obligations No taxation to P/H where: • the sums are received on death, or • the policy is one where premiums paid for any of the years during the term of such policy does not exceed 20% of the actual capital sum assured	WHT obligations on insurer Effectively, no taxation to P/H where: • the sums are received on death, • Sums received under a policy where the premiums paid in any of the years during the policy term do not exceed 5% of the capital sum assured, or • sums received under an approved equity oriented life insurance scheme where tax has been paid on distribution or payment of income by the life insurer

to another non-resident entity (i.e. being an insurance company) can become liable to tax in India to the extent the premium paid relates to the coverage of risk in India.

Conclusion

While the DTC 2010 incorporates certain recommendations made by the industry, there are other representations which have not been accepted and which could significantly change the manner of taxation.

The DTC 2010 is presently with the Standing Committee and further representations are invited from various industries and other forums. Representations by life and non-life companies are being made through their representative bodies. It is important for players in the sector to fully familiarise themselves with the potential impact of these changes, and to engage in further representations to ensure that there is adequate and effective lobbying around any perceived adverse changes in the law.

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Indonesia
Potential tax implications of the new accounting standard for Sharia Insurance

The new Indonesia Accounting Standard (PSAK) 108 on Sharia insurance was implemented on 1 January 2010. In brief, the changes among others are:

- In the past, the premium received from a customer was recognised as premium income in the statement of income. Under this new PSAK, premium income should be recognised as an addition to the Tabarru fund (a liability item).
- Claim expenses, which were previously recognised as expenses in the statement of income, are now recognised as a deduction from the Tabarru fund.
- Investment income (the Tabarru portion), which was previously recognised as investment income, is now recognised as part of an addition to the Tabarru fund.
- Movements in technical reserve and profit sharing will no longer appear in the statement of income. Instead, they will be reflected as part of the movements of the Tabarru fund in the balance sheet.
- The Tabarru fund was not previously shown and now is shown as a liability.
- The Ujrah or fee was previously shown as part of premium income and now it will be recognised separately as Ujrah income.

In summary, most of the profit and loss elements of the Sharia product will no longer appear in the insurance companies' Profit and Loss (or statement of income). They are now recorded as movements of the Tabarru fund in the liabilities section of the Balance Sheet. The remaining item in the Profit and Loss of the insurance company is the fee or Ujrah.

We observe that the new Sharia accounting treatment is a bit similar to that applying to mutual funds now, where the unitholders' or policyholders' fund is no longer recorded under the Profit and Loss of the insurance company. From a commercial bottom line perspective, it may not seem too different as the profit and loss items taken into the Tabarru fund are amounts attributable to the policyholders and would typically be off-set by an equivalent increase or decrease in policyholder liability or reserve.

For Indonesian tax purposes, in the absence of clear guidance from the Indonesian Tax Authorities (ITA), there are issues that the insurance industry needs to be aware of. We set out below some of these issues.

Ujrah income

First, the Ujrah income or the fee – whether there is any VAT risk.

As you may be aware, in the past, the investment charge portion of the insurance income (i.e. excluding the unitised portion used to purchase units in the investment linked fund managed by the life insurer) paid by policyholders to acquire unit linked policies was subjected to VAT by some tax auditors. They did not consider this income as an "insurance service" that is exempted from VAT even though it is recorded as premium income. Fortunately, we have experienced some success in this tax dispute area and VAT was ultimately not imposed.

Now, with the Ujrah income being recognised separately from the unitised portion of the premium income in the Tabarru fund, the same issue may come up again and it may be tougher to argue whether this Ujrah income is premium from an insurance service or non-insurance fee income that could be subjected to VAT.

Under the new VAT Law, there is a clarification on the definition of insurance services that are exempted from VAT. It is stated that the insurance service, for VAT exemption purposes, is insurance coverage that is provided by an insurance company to a policyholder. On this basis, if the scope of the Sharia insurance which generates this Ujrah income still involves the issue of insurance policies and the provision of risk coverage to policyholders, the insurance industry may be in a position to argue that this Ujrah income is still within the scope of insurance services that are exempted from VAT.

Technical reserve
Secondly, the insurance industry must be aware of the corporate tax impact of the change in the Profit and Loss presentation.

One of the most significant deductible expenses in an insurance company's Profit and Loss is its technical reserves. Under Indonesian tax law, for the technical reserve to be deductible, the entire amount of this reserve must be approved by the Capital Market-Financial Institution Supervisory Board (Bapepam-LK).

Under the new PSAK 108, the technical reserve is now recorded in the Tabarru fund and not in the insurance company's Profit and Loss. The issue here is whether the insurance company can still claim a tax deduction for this reserve.

Looking at the formal requirement for Indonesian tax purposes in general, technically, if the reserve in the Tabarru fund is part of the insurance company's reserve that is legalised by Bapepam-LK, the insurance company could claim the reserve as a deductible expense. However, practically, in the absence of clear tax regulation, we anticipate it will be very challenging to claim it as a deductible expense as the expense is not recorded in the insurer's commercial Profit and Loss.

Investment income
The third item that is also interesting is the tax on the investment income which is subject to normal tax rate (not final). We mentioned earlier that, under PSAK 108, the investment income attributable to policyholders would be recorded in the Tabarru fund and that the Tabarru fund would be recorded as a liability on the insurer's Balance Sheet. The issue here is whether such investment income which is ordinarily subject to tax at the normal corporate income tax rate will have to be declared as taxable income of the insurance company.

Take, for instance, dividend income from an equity investment. When the insurance company receives it, 15% of it would have been withheld. However, as this is not final-taxed investment income, it is (all things being equal) subject to a normal corporate tax of 25%. This means that after the initial 15% withholding, the company must top up the remaining 10% by declaring it in its corporate tax return.

Under the new accounting standard, this investment income will not be recorded

We observe that the new Sharia accounting treatment is a bit similar to that applying to mutual funds now, where the unitholders' or policyholders' fund is no longer recorded under the Profit and Loss of the insurance company.

Looking at the formal requirement for Indonesian tax purposes in general, technically, if the reserve in the Tabarru fund is part of the insurance company's reserve that is legalised by Bapepam-LK, the insurance company could claim the reserve as a deductible expense.

in the Profit and Loss of the insurance company. How is it going to top up the remaining 10% if it is not in the Profit and Loss? Should the insurance company add this non-final-taxed investment income to its assessable income declared for tax purposes?

The new Sharia accounting treatment, as mentioned earlier, is a bit similar to mutual funds, whereby all the investment income of the unit holder is accounted for separately, not under the investment manager's books. However, mutual funds have their own tax treatment where a fund, although it is only through a contract, must have its own financial statements and tax ID as if it were a separate entity for tax purposes. Thus, all of the income of the mutual fund will be declared under this tax ID and any top-up of the non-final investment income can be paid through this tax ID.

This, however, is not the case for Sharia insurance. The Tabarru fund does not have a separate tax ID from the insurance company. Everything is recorded under the insurance company so all of the tax obligations of the fund should also be settled through the insurance company.

The tax issues discussed here must be carefully considered when determining the net asset value (NAV) of the Sharia insurance investment-linked units. If an insurance company decides to declare the non-final-taxed investment income by adding it manually for tax purposes, it will have the effect of decreasing the NAV of the units by the amount of additional tax payable (this is a more conservative approach). If an insurance company does not declare the investment income, it may give a better NAV as less tax is paid on the investment income. However, in this case, the insurer would have a potential tax exposure. There would be a risk that the tax authorities would deem there to be an underpayment of tax for the non-final-taxed investment income and charge the insurer for the unpaid 10% tax plus penalties. If this happens, who should bear this tax cost, the insurance company or the Tabarru fund? If it is the Tabarru fund, it would affect the NAV of the units of the fund at that time.

Indonesian Tax Authorities' direction

In a very recent conference held by PwC Indonesia (Financial Services Business Update), we invited the officers from the Directorate General of Taxes (DGT) to share the direction of tax policy on some of the issues the financial services industry is facing due to various changes in accounting standards. Informally, the DGT officers shared that they are currently preparing an implementing tax regulation to address the Sharia insurance business. Hopefully we will all see more clarity on the above issues in the near future.

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Japan

Impact of certain 2010 tax reforms and the Supreme Court's decision on pension benefits

The 2010 Japan Tax Reform introduced numerous changes. In this article, we will discuss two changes that will affect the insurance industry. The first is the introduction of a new group taxation regime that generally defers the taxation of gains and losses arising from certain intra-group transactions. The second is a change in the method of valuing periodic benefits under an amendment to the inheritance tax law.

Another development of significance to the insurance industry in 2010 was a decision handed down by the Supreme Court on 6 July 2010 that has resulted in a change to the income tax treatment of annuity payments made to a beneficiary under an inherited life insurance policy. This decision has retroactive effect and the Ministry of Finance (MoF) and National Taxation Agency (NTA) have issued statements regarding the refund of prior overpayments. In this article, we will also provide an outline of this change.

1. Corporate taxation – introduction of new group taxation regime

The 2010 Tax Reform introduced a new group taxation regime, which will apply to domestic companies ("group companies") that are wholly owned by a domestic company, a foreign company or individual. While the existing tax consolidation regime applies only upon election by the taxpayer, the group taxation regime automatically applies to all group companies.

Generally, the taxation of gains and losses arising from certain intra-group transactions should be deferred until such time as the group relationship between the transacting companies is broken or certain trigger events occur. While the introduction of these rules is generally positive and should allow greater flexibility with respect to domestic group transactions and reorganisations, it will be necessary for taxpayers to maintain documentation to track deferred gains and losses from group transactions and monitor future trigger events.

Generally, the group taxation regime will apply to the following transactions:

1.1 Transfer of certain assets

The recognition of capital gains or losses from the transfer of certain assets between group companies will generally be deferred until the asset is disposed, amortised, revalued, written off or scrapped. Assets covered by the group taxation regime include fixed assets, land, securities, monetary receivables and deferred expenses, but does not include trading stock or assets with a book value of less than JPY 10 million.

1.2 Non-qualified share exchanges

Prior to the 2010 Tax Reform, in the case of a non-qualified share exchange carried out between wholly owned subsidiaries, the company becoming a wholly owned subsidiary via a share exchange was required to recognise built-in gains or losses in respect of its assets. This treatment is no longer required.

1.3 Donations

Where a donation (i.e., transfer of assets or provision of services for more or less than their fair market value) occurs

While the introduction of the group taxation regime is generally positive and should allow greater flexibility with respect to domestic group transactions and reorganisations, it will be necessary for taxpayers to maintain documentation to track deferred gains and losses from group transactions and monitor future trigger events.

between group companies, the donee should not be subject to tax on the donation income, and the donation expense should be entirely non-deductible for the donor. This treatment does not apply to group companies wholly owned by individuals.

1.4 Dividends-in-kind

Following the 2010 Tax Reform, where a group company transfers a non-cash asset in satisfaction of a dividend (or deemed dividend), the asset should be transferred at book value and no gain or loss should be recognised by the company. Further, the dividend should not be subject to withholding tax. This treatment is only applicable where all of the shareholders receiving the dividends are group companies.

1.5 Dividends

Following the 2010 Tax Reform, dividends received by a domestic company from another group company are fully excluded from taxable income provided that the shareholder owns 100% of the shares through the entire dividend calculation period, without any reduction of allocable interest expense under the "dividend received deduction" rule. This treatment will apply to foreign companies in Japan.

1.6 Repurchase of shares

Where a repurchase of shares occurs between group companies, the shareholder should not be required to recognise any capital gain or loss and any deemed dividend that arises as a result of the repurchase should be fully excluded from taxable income as described above at 1.5.

2. Inheritance tax – new valuation method for periodic benefits

The 2010 Tax Reform, has modified the inheritance tax valuation method for periodic benefits. This affects the valuation of individual annuities.

Prior to the 2010 Tax Reform, the valuation method adopted for a periodic benefit depended on whether payment of the periodic benefit had started and whether or not the benefit was a lifetime benefit or not. In either case, however, the value of the benefit was determined by reference to a fixed multiple of annual payments or a fixed portion of the total benefits depending on the number of years of periodic payment remaining.

As the existing valuation method for periodic benefits was not considered to appropriately reflect the net present value of future payments in connection with the benefit, the method was revised.

Under the new valuation method, the value of an individual annuity for inheritance tax purposes would be determined as follows:

(1) If the payment of the periodic benefit under the annuity has started, the greater of:

- the cancellation value of the annuity;
- if the heir can elect to have the annuity paid out in a lump-sum payment, the amount of the lump-sum payment; or
- the amount computed based on the guaranteed yield of the annuity.

(2) If the payment of the periodic benefit under the annuity has not started, then the value is determined as the amount that would be received on cancellation of the annuity contract.

This modification applies to inheritances received on or after 1 April 2010, although certain benefits may be subject to transitional measures.

3. Supreme Court's decision on the double taxation of life insurance pension benefits

On 6 July 2010, the Supreme Court handed down a decision in favour of the taxpayer in a case on the income tax treatment of annuity payments made to a beneficiary under an inherited life insurance policy.

3.1. Outline of the case

In this case, the taxpayer argued that annuity payments received in connection with a life insurance policy that the taxpayer had inherited, and which had been subject to inheritance tax, should be treated as tax exempt income for Japanese income tax purposes.

Generally, a life insurance policy is treated as an inherited asset for inheritance tax law purposes and the value of the policy is subject to inheritance tax. Under Japanese income tax law, income from inheritance, bequests, gifts or donations from an individual are generally not subject to tax. However, the NTA typically levies income tax on the annuity payments received from an inherited life insurance policy as they do not consider the annuity payments as income derived from inherited assets.

3.2 Brief summary of the Supreme Court decision

The Supreme Court ruled that the annuity payments, the value of which has been treated as a taxable asset for inheritance tax purposes, should not be treated as taxable income for Japanese income tax purposes. The Supreme Court's decision was based on the following reasons:

- The purpose of the tax exemption clause is to reduce the incidence of double taxation on the same economic benefit;
- As the value of the taxable asset of an inherited life insurance policy reflects the present value of the future annuity payments, the annuity payments should be considered to be the asset for income tax purposes; and
- On this basis, the exempted income for the purposes of the income tax law should be the income derived from the asset which the heir has inherited from the deceased, and not the asset itself.

As the first annuity payment under a life insurance policy is typically made within a reasonable period of the date of death of the insured, there is generally no present value discount reflected in the value of the life insurance policy for this payment for inheritance tax purposes. However, for future payments, the taxed valued for inheritance tax purposes reflects a present value discount for these payments, and it is not clear from the Supreme Court's decision whether the value of that discount should be subject to income tax in the future when received.

3.3 Impact of this decision

The MoF and NTA have both released statements on the Supreme Court's decision stating that they will issue refunds to taxpayers for overpaid income tax with respect to inherited insurance annuities.

Japanese life insurance companies are not only sellers of the insurance products but also withholding tax agents with obligations to withhold income tax, at each annuity payment, from the recipient under Japanese income tax law. In this regard, the Life Insurance Association of Japan has filed an industry petition requesting a simple and easy to understand tax treatment for taxpayers for this issue. Further details are expected in relation to the process for refunds.

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Korea

K-IFRS implementation and the tax impact on equalisation reserves

All financial institutions (excluding savings banks, leasing companies, etc.) are required to adopt Korean IFRS (K-IFRS) from 2011. In this article, we will discuss the impact of K-IFRS adoption on the tax treatment of equalisation reserves for non-life insurance companies.

Accounting

An equalisation or catastrophe reserve is a contingency reserve typically maintained by non-life insurance companies as a buffer against unforeseen but possible catastrophes, such as earthquakes or floods. Generally, regular amounts are set-aside to the equalisation reserve yearly by the insurers, and should a catastrophe occur, the reserve may be utilised to pay out losses. These equalisation reserves thus play a part in smoothing out the earnings of a non-life insurer. It can also help avoid a situation where a catastrophe wipes out all the reserves of an insurer.

Under the old Korean accounting standards (K-GAAP), equalisation reserves are held as "liabilities" on the balance sheet of non-life insurers and the amounts set-aside to the reserve are reflected as an expense in the insurers' profit and loss.

Under the new K-IFRS, the holding of contingency reserves is no longer allowed and these equalisation reserves must be excluded from the insurers' technical provisions.

Current tax treatment

Currently, under the Korean Corporate Income Tax Act (CITA), an amount set-aside to an equalisation reserve is deductible for tax purposes if the said amount is recorded as an expense and the equalisation reserve is recorded as a liability in the insurer's financial statements for K-GAAP and Korean statutory accounting purposes.

Disallowance of equalisation reserves under K-IFRS

Upon first time adoption of K-IFRS, all equalisation reserves will be written back to retained earnings. To give a sense of the magnitude of the amount involved, the total equalisation reserves accumulated in non-life insurance companies as at 31 Mar 2010 was reported to be KRW 3,545 billion (approximately USD 3.1 billion).

Under the current CITA, the amount written back to retained earnings would be subject to corporate income tax at a rate of 24.2% (including surtax). Using the balance of KRW 3,545 billion as an indicative guide, Korea's non-life insurers could face a potential tax exposure of KRW 857 billion (approximately USD 762 million) in FY 2011 from this issue.

Due to this huge exposure, the General Insurance Association of Korea (GIA) sought a tax amendment from the Ministry of Strategy and Finance (MOSF) that would allow insurance companies in Korea to claim tax deductions for equalisation reserves without the need to have the relevant amounts expensed and recognised in the books of the insurers. The GIA proposed that the equalisation reserves would be tracked separately for tax purposes and that details would be provided in a form to be filed by the insurer together with and at the same time the corporate tax return is filed.

The GIA's contention is that there is no change in economic activity after the IFRS adoption and the tax burden was a disproportionate cost to the insurers.

MOSF Guidelines of tax changes under K-IFRS

The MOSF has taken the stance that the existing tax law should basically stay the same with only minor adjustments and changes being made to the tax law. In a statement released on 1 July 2010, the MOSF presented the guidelines by which the CITA would be amended upon adoption of K-IFRS. The guidelines are as follows:

1. Consistent tax burden on the same economic activities

For areas where the adoption of K-IFRS creates a permanent discrepancy in tax costs between K-IFRS users and non-users or a steep fluctuation of taxable income year by year, the tax law shall be changed in a way to impose consistent tax burden on the same economic activities.

2. Minimise tax adjustments where there is no material difference in tax burden

In the areas where tax adjustments are too complicated for no material difference in tax burden or for only minor temporary differences, the tax law may be revised in a way to follow the accounting treatment.

3. Accept the new accounting policy where it is more reasonable for tax purposes

In areas where it is reasonable to keep the existing tax treatment but the tax treatment resulted in an increase in tax burden, temporary or transitional measures may be introduced to alleviate the tax burden of the taxpayers.

MOSF's decision on equalisation reserves

When preparing the above guidelines, the MOSF considered feedback from representatives of GIA and its PwC advisors. The MOSF also reviewed a report from a governmental tax research institute to determine the manner by which other countries treat equalisation reserves.

The MOSF's decision is that equalisation reserves should continue to be tax deductible even though the reserve is not allowed as an expense under K-IFRS. This decision was based on guideline 1 above "Consistent Tax Burden on the Same Economic Activities". If equalisation reserves were no longer deductible, the tax burden for the same economic activities would greatly increase.

Although the MOSF has decided to allow a deduction for equalisation reserves, the proposed amendments to the tax law is still in progress. Currently, the MOSF is reviewing certain practical matters such as whether a limit should be placed on the deduction claimable to deter the accumulation of excess reserves and avoiding tax. The issue is not over yet and insurers are advised to follow the developments closely.

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Malaysia

The 'perfect storm' of GST issues facing non-life and life insurers

The Malaysian Goods and Services Tax Bill 2009 ("the GST Bill") was tabled in Parliament on 16 December 2009. The GST Bill is designed to tax the consumption of goods and services within Malaysia at a proposed rate of 4%. The Government has recently announced the postponement of the implementation of the goods and services tax (GST). However, the Government maintains that the GST is still important in ensuring a strong and sustainable fiscal position for Malaysia's long-term growth.

The application of the proposed GST to the Malaysian insurance industry will create a 'perfect storm' of issues for Malaysian Government policy makers and the insurance industry alike. This article will outline some of these key issues.

Settlement of claims for non-life insurers

Supplies of non-life insurance will be subject to GST in Malaysia. Unlike life insurers, GST incurred will be recoverable and hence not a cost to non-life insurers. However, the GST issues surrounding the payment of insurance settlements are complex.

There is debate in GST jurisdictions as to whether a settlement payment made by an insurer is consideration for a supply made by the insured. Some view the surrender of rights by the insured to seek damages under an insurance policy as a supply for GST purposes. If so, then GST would be applicable on settlement payments. Others interpret such acts as merely the insurer performing its obligation to indemnify the insured pursuant to the insurance policy. As a result, many jurisdictions (such as Australia), do away with such debates with special rules to ensure no GST falls on settlement payments.

However, there still remains the issue of ensuring that the GST payable by insurers equates to their 'value add', being their margin between GST payable on the supply of premiums and GST incurred in making settlement payments.

If settlement payments are not subject to GST, the insurer is not able to claim input tax on settlement payments. This would increase costs for the insurer, the repercussion being potentially higher premiums for the insured.

To deal with this issue, many jurisdictions apply a special rule which ensures that the insurer is entitled to a deemed credit in certain instances when making cash settlement payments to non GST-registered persons. This ensures that the insurer's settlement costs will not be impacted. The deemed input tax would be calculated as follows:

$$\text{Settlement amount} \times \frac{\text{GST rate}}{100\% + \text{GST rate}}$$

Example

An insured individual (not GST-registered) has a car accident and claims against his policy for RM1,040 (inclusive of RM40 GST) to repair the car. This is the quote for repairs from a GST registered car repair workshop. As the insured is not GST-registered, the 'loss' to him is RM1,040 as he cannot claim back the RM40 GST. The insurer makes the settlement payment to the insured for the full amount of RM1,040 (including the RM40 GST).

Without the deemed credit rule, the insurer's settlement costs would have increased by RM40 due to the insured's inability to claim the GST. However, with the deemed credit rule, the insurer would claim a deemed input tax credit for the RM40 (being RM1,040 x 4/104).

The above deemed credit rule, has been the practice in countries such as Australia and Singapore. Generally, the credit is available when the insurance premium is subject to GST, the insured is not a GST-registered person, the settlement is for cash and the settlement payment is made to non GST-registered persons.

In the case of a GST-registered insured, the insured would be able to claim the input tax incurred. Using the same example above, the insured would claim back the RM40 GST charged by the workshop. His loss would thus only be RM1,000 and the insurer's claim settlement would only be RM1,000 exclusive of GST. In this instance, the insurer would not be entitled to the 'deemed credit'.

A consequence of treating riders attached to life insurance policies as GST exempt is that it would disadvantage non-life insurers selling the same products on a "stand alone" basis as they would be subject to GST, thereby increasing the cost to 'price sensitive' consumers.

GST and life insurers

In Malaysia, it is proposed that the supply of life insurance will be exempt from GST. Exempt treatment implies no GST will be levied on supplies of life insurance but at the same time GST incurred in making supplies of life insurance cannot be claimed by GST-registered life insurers.

Hence, GST incurred will become a cost to life insurers. Exemption will also increase compliance costs for life insurers as they will be required to track and attribute GST incurred between life (non-claimable) and non-life (claimable) activities. This will have the potential to lead to higher premiums and potentially impede the competiveness of the life insurance industry in Malaysia.

Options to alleviate irrecoverable GST for life insurers

To alleviate the cost of irrecoverable GST for life insurers, various options are available to the Malaysian Government, as experienced in other GST jurisdictions.

One option could be for the Government to allow 100% full recovery for GST attributed to specific expenses, such as commissions and brokerage paid and specified outsourced expenses incurred on life policies.

The use of agents and the remuneration of these agents via commissions is a significant feature of the life insurance business. It is estimated these commissions make up 10-20% of the life insurance industry's operating cost. Presently, these commissions do not attract service tax. The situation will change under the proposed GST regime and these commissions may attract GST at 4% with no prospect of recovery to the life insurer. The life insurance industry will be faced with the prospect of erosion of its life fund if they do not increase life insurance premiums to make up for this additional expense. The added complication is that this burden may be shifted to premiums for new policies as the premiums of existing life insurance policies are already fixed by contract.

One of the desirable features of a tax is neutrality and the lack of distortionary effects of introducing the tax. The GST treatment of not allowing recovery of input tax on commissions is therefore contrary to the features of a neutral tax if it pushes the life insurance industry to change its behavior as a result of the introduction of the tax. The impact would also run contrary to the goals of the Government to encourage a greater level of protection of the people through taking on greater life insurance coverage.

Another option could be to allow a recovery of a fixed percentage of GST incurred for life policies. This percentage could be based on a proxy of the level of business-to-business conducted by the insurer, as a means to avoid tax cascading (GST on embedded GST).

Perhaps a compromise solution is a concession for a limited period, say 5 years, so that adjustments to premiums can be phased in to smoothen the impact of irrecoverable input tax credits. These measures would go someway to alleviate the problems of irrecoverable GST for life insurers.

To bundle or not to bundle?

There are also GST complications arising from the insurance industry's practice of bundling together both non-life (GST taxable) and life (GST exempt) insurance policies to customers, often referred to as 'riders'. When such bundling happens there are two possible GST treatments, both with different consequences.

One option is for the GST treatment of 'riders' to follow the GST treatment of the main policy.

A consequence of treating riders attached to life insurance policies as GST exempt is that it would disadvantage non-life insurers selling the same products on a "stand alone" basis as they would be subject to GST, thereby increasing the cost to 'price sensitive' consumers. All things being equal, insurance policies sold by non-life insurers would be less competitive compared to the same cover offered as riders by life insurers.

Another option for the Government is to treat riders on a "stand alone" basis for GST purposes. This would mean that insurance policies such as personal accident, medical and hospitalisation policies, which commonly ride on life insurance plans, would be subject to GST. Only the pure life policy portion would remain GST-exempt. Unbundling of premiums of combined policies will be required.

The need to unbundle combined insurance policies for GST purposes would increase administrative and compliance costs for the insurers. However, it would ensure tax neutrality, i.e. the same GST treatment would apply on the insurance supplied, regardless of whether it is supplied as a rider or on a stand alone basis.

Concluding remarks

There are many GST issues facing the Malaysian Government policy makers and the insurance industry. The main concerns are minimising settlement costs for non-life insurers, minimising irrecoverable GST for life insurers and minimising market place distortions in the case of composite supplies of insurance.

Irrecoverable GST resulting from GST exemption for life insurers and increased settlement costs for non-life insurers may put upward pressure on the pricing of premiums to policyholders. This would likely impact individuals the most. The challenge for Malaysian Government policy makers (and the industry) is to mitigate higher premiums and market place distortions, while maintaining the profitability and competitiveness of the insurance industry moving forward.

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New Zealand

Impact of GST rate change for insurers

As part of the 2010 New Zealand budget tax changes, it was announced that the Goods and Services Tax (GST) rate would increase from 12.5% to 15% for supplies of goods and services made on or after 1 October 2010. There are particular implications to the insurance industry as the majority of insurance contracts straddle the GST rate change date. In addition, the transitional rules enacted are also applicable to insurance contracts.

Background

GST is a consumption tax imposed on the supply of goods and services in New Zealand and is generally borne by the final consumer. Non-life insurance premiums are liable to GST, whereas life insurance premiums are considered an exempt supply. The time of supply for insurance services is generally the earlier of the time an invoice is issued or when payment is received.

GST applied to insurance contracts and impact of the rate change

Premiums

The GST rate applicable to premiums will depend on the time of supply of services under the contract of insurance. Premiums invoiced prior to 1 October 2010 will generally not be subject to the new GST rate of 15%, even if cover does extend beyond 1 October 2010.

Although each case must be considered according to the terms of the underlying insurance contract, in general, a renewal notice will not constitute an "invoice" for the purposes of determining time of supply.

Indemnity payments received by GST registered persons

An indemnity payment received by a registered person under a contract of insurance is deemed to be consideration for a supply of services performed by the recipient on the date of receipt. Accordingly the "tax fraction" [equal to GST rate/(100% + GST rate)] of the indemnity payment must be paid as output tax. The 15% rate will apply to payments received on or after 1 October 2010, regardless of when the claim was lodged or the loss occurred.

For an insurer, the associated deduction for the tax fraction of indemnity payments is allowed on a payments basis provided certain conditions are met. Indemnity payments made up to 30 September 2010 will therefore give rise to a deduction of 1/9th (being 12.5/112.5) of the GST inclusive payment and payments made on or after 1 October 2010 will give rise to a deduction of 3/23rd (being 15/115) of the GST inclusive payment.

Variations in contract pricing resulting in credit/debit notes

Insurers will need to ensure that credit and debit notes for variance in contract pricing are issued at the same GST rate as used when the premium was originally invoiced.

Transitional rules

Transitional rules have been enacted to alleviate the burden on taxpayers in complying with the rate change. The rules are not insurance specific, but have application to the insurance industry in the areas of successive contracts and subrogation recoveries.

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Successive contracts
In some cases, insurance cover is provided pursuant to an agreement under which premiums are paid periodically over the period of the cover. Ordinarily, each successive supply is deemed to take place at the earlier of the time the payment is due or is received (i.e. it does not matter when an invoice was issued). Accordingly, where a premium instalment is due or is received before 1 October 2010, GST may be accounted for at 12.5%. However, the transitional rules allow GST to be locked in at 12.5% for contracts entered into before 1 October 2010 even though payments are not received or due until after 1 October 2010.

The new transitional rules will apply to contracts (with a term of one year or less or are reviewed annually) entered into before 1 October 2010 if:

- the customer is able to pay the price on a periodic (e.g. monthly) basis, or
- the contract has an option to pay up front but that option has not been exercised.

The main provisions for contracts to be eligible for 12.5% GST are:

- the contract has an option to pay up front but that option has not been exercised.
- where the supply is to a GST-registered business, the supplier will be required to notify the recipient the GST deduction must be at 12.5%.

Example
The premiums payable for an insurance policy covering the period 1 April 2010 to 31 March 2011 is $1,000 and the customer chooses to pay by monthly instalments. The insurer normally pays GST when instalments are due or received but elects to apply the transitional rules and returns the remaining GST at 12.5% in its September GST return. We have illustrated the impact of the transitional rules on successive contracts in Table 1 below.

Monthly contracts do not have the ability to pay GST in advance and must pay GST of 15.0% for monthly contracts renewed after 1 October 2010. Companies that structure their contracts in this way are therefore at a competitive disadvantage.

Table 1 – Illustration of impact of transitional rules

	GST burden with transitional rules	GST burden without transitional rules
1 April 2010 – 30 September 2010*	$1,000 x 12.5% = $125	$1,000 / 2 x 12.5% = $62.50
1 October 2010 – 31 March 2011	$0	$1,000 / 2 x 15% = $75
Total	$125	$137.50

* The transitional rules deem the supplies not already made to be made on 30 September 2010

Impact of rate change on subrogation recoveries

Subrogation payments received on or after 1 October 2010 would ordinarily be subject to the new 15% GST rate, even when the underlying claim to which the payment relates was at 12.5%. However, the transitional rules suspend this asymmetric result so that insurers are not out of pocket for insurance subrogation recoveries where the claim is settled or resolved on or before 30 September 2010 but the subrogation payment is received after that date.

Summary

The above rules are summarised in the table 2 below.

The GST rate change has caused a number of issues for insurance companies. As it is a relatively rare event (the last change was over 20 years ago), it has forced insurers to update their GST systems and reconsider when they are accounting for GST. The transitional rules have provided concessions to some insurers but these rules need to be carefully managed.

Many insurers have dealt with the challenges and will continue to do so after 1 October 2010. However, with every change, there is opportunity and businesses have recognised the potential positives presented by the rate increase.

Table 2 – Summary of impact of GST rate change

General Rules	12.5%	15%
Premiums invoiced pre 1 October 2010	✓	
Premiums invoiced on or after 1 October 2010		✓
Indemnity payments made/received pre 1 October 2010	✓	
Indemnity payments made/received on or after 1 October 2010		✓

Transitional Rules	12.5%	15%
Annual contract with successive periodic payments extending beyond 30 September 2010	✓	
Monthly contract extending beyond 30 September 2010		✓
Subrogation recoveries received on or after 1 October 2010 where claim is on or before 30 September 2010	✓	

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Philippines

Tax breaks for life insurance

The local life insurance industry is among the most heavily taxed compared with its Asian counterparts. For every life insurance product sold, the corresponding premium tax and documentary stamp tax (DST) are normally collected. Income earned by insurance companies from the conduct of insurance business is subject to 30% net income tax or 2% minimum corporate income tax, whichever is higher while income generated from its investment income is generally subject to 20% final withholding tax. In addition, its gross receipts are subject to local business tax.

New Law

It was a welcome respite for the industry when Republic Act (RA) No. 10001 – An Act Reducing the Taxes on Life Insurance Policies – was signed into law early this year.

It was a welcome respite for the insurance industry when RA 10001 – An Act Reducing the Taxes on Life Insurance Policies – was signed into law early this year.

The law amended Sections 123 (Premium tax) and 183 (Documentary stamp tax) of the National Internal Revenue Code. Specifically, it reduced the premium tax imposed on life insurance premiums from 5% to 2%. The reduced tax rates are applicable to insurance policies sold after the effectivity of the law and to future payments.

On the other hand, the DST which used to be 0.25% of the premium collected has been reduced to the following graduated rates: no charge for policies lower than Php 100,000; Php 10 for policies worth more than Php 100,000 to Php 300,000; Php 25 for those worth more than Php 300,000 to Php 500,000; Php 50 for policies worth more than Php 500,000 to Php 750,000; and Php 100 for those worth more than Php 750,000 to Php 1 million.

The law, however, effectively reinstated the "one-time" collection of DST which is based on the total face value of the policy at the time of approval of the insurance contract. Since the DST is paid upfront and not refundable regardless of the possible cancellation of the insurance contract in the future, it may be a significant add-on cost to the policy holder.

Amended version

It is worthy to note that under the original version of RA 10001 approved by Congress, life insurance premiums shall no longer be subject to premium tax and DST after five years from the effectivity of the law. However, the then President Gloria Arroyo vetoed this provision on the ground that it violated the Constitutional mandate that taxation should be uniform and equitable. From the view of the President, the exemption, if granted, will result in inequity since other financial instruments will continue to be taxable and may set a precedent for other players in the financial sector to clamour for the same tax treatment that will further put government revenues at risk. Moreover, the exemption would only benefit insurance providers rather that the insurance buyers. Unfortunately, Congress did not exercise its authority to override the veto.

Increase affordability

Nevertheless, the tax reduction introduced by RA No. 10001 should somehow ease the cost of doing business of life insurance companies. Consequently, it should make life insurance a more affordable commodity for Filipinos. Price has always been a critical factor in determining the marketability of any product or service, insurance products included. A reduction in the price of insurance premiums should produce a positive effect.

Based on statistics from the Insurance Commission of the Philippines, life insurance companies posted premium income of only Php57.24 billion (approximately US$1.30 billion) in 2009, a measly increase of less than 1% from the 2008 data of Php56.89 billion (US$1.29 billion). Indications pointed to flat growth in premium income in 2009 due to the impact of the global economic crisis last year.

Hopefully, the tax breaks under RA No. 10001 would contribute to a marked improvement in the life insurance industry this year. But this remains to be seen.

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Singapore
Application of the Productivity and Innovation Credit Scheme to insurers

This year, there were no significant tax hand-outs to the insurance sector. But it does not mean that insurers were left out. Insurers can still look to other broad-based tax measures to obtain some tax benefits from the current year changes.

Productivity and Innovation Credit Scheme

One of the major initiatives in the Singapore 2010 Budget was the introduction of a broad-based tax concession scheme entitled the Productivity and Innovation Credit Scheme (PIC). It is aimed at encouraging innovation and enhancing productivity. It provides for enhanced deductions and allowances for qualifying expenditure incurred on six specified activities.

a) Research and development (R&D) done in Singapore

b) Design work (relating to an industrial or product design project) done in Singapore

c) Investments in automation

d) Training of employees

e) Acquisition of intellectual property (IP) rights

f) Registration of IP rights

The PIC will be available for five years starting from the year of assessment (YA) 2011.

What is available?

Under the PIC, businesses will be entitled to claim a tax deduction for 250% of qualifying expenditure incurred for each activity, subject to:

- a combined cap of S$600,000 of qualifying expenditure for each category of activity for YAs 2011 and 2012

- a cap of S$300,000 of qualifying expenditure for each activity for each year for YAs 2013 to 2015

Any expenditure in excess of the cap will continue to enjoy deductions or allowances at current levels.

Where the qualifying expenditure on a qualifying activity is funded or subsidised by the Government or a statutory board, only the amount of expenditure net of the grant or subsidy is eligible for enhanced deductions under PIC.

Assuming the relevant expenditure is one where a taxpayer would have been entitled to a 100% tax deduction, the impact of the PIC is another 150% additional deduction. On a qualifying expenditure of S$300,000, this works out to an effective tax benefit of S$76,500 (being S$300,000 x 17% x 150%) for each YA, for each category of activity. The potential tax benefit over five years for each category of activity is S$382,500 (S$76,500 x 5), certainly not a small sum. And if a taxpayer qualifies for more than one activity, the benefits are multiplied accordingly.

Insurers are therefore encouraged to understand how the PIC could apply to their circumstances and avail themselves to the scheme.

Businesses with more than one tax rate

In an Inland Revenue Authority of Singapore (IRAS) guidance issued on the PIC in June 2010, it was stated that for a business whose income is taxable at the prevailing corporate tax rate ("normal income") as well as at one or more concessionary rate(s) ("concessionary income"), the enhanced deductions shall be granted in the following order:

- firstly against normal income,
- next against concessionary income that is subject to tax at the highest concessionary rate,
- then followed by concessionary income that is subject to tax at the next highest concessionary rate, etc

The above is of particular interest to insurers with offshore insurance business (OIB) income taxable under the concessionary rate of 10%, qualifying debt securities income (S43N income) taxable under 10% and/or exempt income under other incentive schemes. Does it mean that the enhanced deductions will be set-off against income taxed at the prevailing corporate tax rate (17%) first, then against OIB income and S43N income (10% rate) and lastly against exempt income (0%)? As is usual with tax laws, the devil is in the details, and we'll have to see how this pans out in practice.

Unutilised deductions

Enhanced deductions which are not fully offset against the income of a business would typically form part of the tax loss or capital allowance of the business in the usual manner, and may be carried forward for offset against future income, or carried back, or transferred under group relief, based on existing tax rules.

Cash conversion option

To assist small and medium enterprises (SMEs) with growing businesses but a lack of taxable income, there is an irrevocable cash conversion option for qualifying businesses. Such qualifying businesses may opt to convert up to S$300,000 of their qualifying deductions for each YA into a non-taxable cash grant at the rate of 7% (i.e. a payout of up to S$21,000 per annum). The taxpayer is not allowed to make a partial conversion. This option is only available for YAs 2011 to 2013 and is meant to support SMEs with low taxable incomes that need cash to fund their investments in technology or upgrade operations. For YAs 2011 and 2012, the cap on the amount of qualifying deduction/allowances that can be converted into cash will be combined, making it a total of S$600,000 for the two YAs.

An insurance company could technically qualify for the cash conversion option if it employs and makes contributions to the Central Provident Fund in respect of not less than three local employees (generally defined to be Singapore citizens or permanent residents). However, at only 7% of the qualifying deduction, the cash option is inferior to a tax deduction and we foresee few situations that an insurer may wish to take up the cash option.

Rules, procedures and claw-backs

Other than for design projects (activity (b) above), no prior application or approval is required for claiming deductions under PIC. However, businesses claiming the enhanced deductions must maintain adequate records of their qualifying activities and expenditures and provide them to IRAS upon request.

Each of the six categories of qualifying activities has its own detailed rules on what may be the qualifying expenditure, the qualifying activity and the manner of claim. There are also specified claw-back provisions, typically, if certain conditions are not met or a relevant asset is disposed off within a year.

What's applicable to insurers?

Not all of the above six qualifying activities are activities that an insurer would typically engage in. For example, insurers are not likely to engage in activities (a) and (b) above, i.e. for qualifying R&D done in Singapore, and for qualifying design work done in Singapore in relation to an industrial or product design project.

Thus, we have limited our discussion below to the other remaining four activities that insurers may potentially engage in.

Investments in automation

This activity category provides for enhanced capital allowance claims and deductions for investments in prescribed automation equipment.

Currently, under section 19A of the Income Tax Act (ITA) businesses that incur expenditure on "prescribed automation equipment" can qualify for a 100% capital allowance claim in the year of expenditure. Under PIC, businesses will be able to claim an additional 150% allowance (making it 250% allowance in total) for the first S$300,000 of expenditure incurred on qualifying automation equipment per qualifying YA, with the threshold for YAs 2011 and 2012 measured on a combined basis at S$600,000.

In the aftermath of the financial crisis, we observe that many insurers are now ramping up their investments in technology.

Should a business choose to lease the prescribed automation equipment instead of acquiring it, the lease expenditure can, under the new section 14T, also be counted as qualifying expenditure under PIC. However, the same annual expenditure cap shall apply to both expenditure incurred on the acquisition and leasing of the prescribed automation equipment.

"Prescribed automation equipment" will be based on the current list of automation equipment in the Income Tax (Automation Equipment) Rules 2004 which will be updated and expanded to include a wider range of equipment for automating processes. It would include data processing and IT equipment, data communications and networking equipment, image and graphics processing equipment, automated storage and retrieval information systems, office systems software and IT software.

In the aftermath of the financial crisis, we observe that many insurers are now ramping up their investments in technology. Some of this is driven by the need to improve sales platforms, enhance the consumer experience and automate processes. Yet others are driven by the need to replace or improve on outdated accounting systems to cope with the ever changing regulatory landscape. The enhanced deductions under this category of activity, though small in relative terms, should still be a bonus to the insurance industry.

Training of employees

This activity category provides for enhanced deductions for qualifying training expenditure incurred on employees and should be applicable to all insurers.

Currently, businesses that incur expenditure on training its employees can claim a 100% tax deduction subject to the general tax deduction rules under sections 14 and 15 of the ITA.

To encourage continual upgrading of skills of the workforce, under the new section 14R, a further 150% deduction is granted on the first S$300,000 of qualifying training expenditure (net of grants) incurred in the basis period for a qualifying YA, with the threshold for YAs 2011 and 2012 measured on a combined basis at S$600,000.

The enhanced deduction for qualifying training expenditure under PIC is generally available for training provided through an external training provider and includes:

- training fees payable to the external training service provider;
- registration or enrolment fees;
- examination fees;
- tuition fees; and
- aptitude test fees.

For trainings conducted in-house by employees of a business, the enhanced deduction is restricted to qualifying expenditure incurred in relation to the provision of the qualifying training programmes. These qualifying in-house training programmes are certain specified Workforce Skills Qualification (WSQ) training courses certified by the Workforce Development Agency, structured Institute of Technology (ITE) courses under the ITE Approved Training scheme and certain on-the-job ITE certified training courses.

Qualifying training expenditure would include meals and refreshments provided during courses, as well as training materials and stationery used for such training. However, it would exclude any accommodation, air tickets, travelling and transportation expenditure incurred in respect of employees attending courses.

Acquisition of IP rights

This category of activity provides for an enhanced writing-down allowance (WDA) on capital expenditure incurred in acquiring IP rights.

Currently, under section 19B of the ITA, 100% of the costs of acquiring IP rights can be amortised for tax purposes on a straight-line basis over five years (two years for approved IP relating to media and digital entertainment content). The current definition of IP rights refers to any patent, copyright, trademark, registered design, geographical indication, layout of design of integrated circuit, and trade secret or information that has commercial value. The taxpayer is required to own both the legal and economic rights to the IP. Specific approval is required from the EDB to claim the amortisation benefits where the taxpayer ends up acquiring only the economic rights to the IP.

Under PIC, the definition of IP rights is expanded to include plant varieties. In addition, a further 150% (making it 250% in all) WDA is granted on the first S$300,000 of the capital expenditure incurred to acquire IP rights in each basis period, subject to certain conditions.

There could be instances where insurers could benefit from a section 19B allowance and the enhancement under the PIC, for example, where a business changes hands and the buyer of the business acquires certain IP rights associated with the business.

Registration of IP rights

This activity category provides for an enhanced tax deduction for costs incurred for registering patents, trademarks, designs and plant varieties, referred to as "patenting costs" and "qualifying IP registration costs" under section 14A of the ITA.

Currently, businesses can claim a 100% deduction for expenditure incurred on registering patents. The deduction is allowed on the condition that the legal and economic ownership of the patent belong to the business entity in Singapore.

Under PIC, the scope is expanded to allow deduction of costs incurred in registering trademarks, designs and plant varieties. It also provides for an enhanced tax deduction of another 150% (making it 250% in total) for the first $300,000 of patenting costs and qualifying IP registration costs incurred in the basis period of a qualifying YA, with the threshold for YAs 2011 and 2012 measured on a combined basis at S$600,000.

The qualifying costs include official fees (application payments made to the Registry of Patents, Registry of Trade Marks, Registry of Designs or the Registry of Plant Varieties, etc, in Singapore or elsewhere) and professional fees incurred in relation to the registration of the qualifying IP rights. The enhanced deduction is granted regardless of the outcome of a particular application.

This category of activity could have some application to insurers who may be modifying their logos or names or who may need to expand overseas and deem it necessary to register their Trade Marks and/or particular names/designs in the overseas locations.

Concluding comments

While the PIC is primarily aimed at SMEs and is of greater application to design, technology and manufacturing activities, there are still benefits available to financial services entities such as insurance companies. We see significant benefits for all insurers investing in automation, IT and software. We also see benefits in enhanced deductions for employee training costs. The activities relating to IP rights, though of more limited application, should still be borne in mind.

As the enhanced deductions over the five years are limited to S$300,000 per year (with YA 2011 and 2012 measured on a combined basis of S$600,000) per activity, insurers should review their expenditure plans to make the most of the available benefits under the PIC.

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Taiwan
Recent tax developments affecting insurers

There are two important tax developments affecting the insurance industry in Taiwan. First, the corporate income tax rate has been reduced to 17%, which will be favourable for insurance companies.

Second, Taiwan courts have recently ruled remuneration for services rendered offshore but utilised onshore as Taiwan-sourced income, which disregarded the primary principle of the Guideline for Determination of Taiwan-sourced Income under Article 8 of the Income Tax Act ("the Guideline"). Such decision may have an unfavourable effect on insurance companies that make payments offshore.

The Legislative Yuan passed a landmark bill to reduce the corporate income tax rate from 25% to 17%, effective from fiscal year 2010 onwards. The tax rate was initially reduced to 20%, but was further cut down with an aim to boost Taiwan's international competitiveness.

Reduced corporate income tax rate to 17%

On 28 May 2010, the Legislative Yuan passed a landmark bill to reduce the corporate income tax rate from 25% to 17%, effective from fiscal year 2010 onwards. The tax rate was initially reduced to 20%, but was further cut down with an aim to boost Taiwan's international competitiveness. However, the standard withholding tax rate for various incomes still remains at 20%.

According to the Ministry of Finance (MOF), the tax cut should enhance Taiwan's international competitiveness, drive economic and industrial development.

The lowered tax rate of 17% can reduce insurance companies' tax burden, and thus increase their business competitiveness in Taiwan.

Supreme Administrative Court ruled remuneration for services rendered offshore but utilised onshore as Taiwan-sourced income

For years, the National Tax Administration (NTA) has deemed fees paid for services rendered outside of Taiwan but utilised in Taiwan to be Taiwan-sourced until the recent announcement of the Guideline that was supposed to reduce controversies of Taiwan-sourced income.

However, recently, Taiwan courts (including the Supreme Administrative Court) have over-ruled the claim of business profits as non-Taiwan-sourced income under Article 8 Item 9 of the Income Tax Act (ITA), thus ignoring the principle set in the Guideline that the location where the services are rendered shall be the determinant of whether an income is Taiwan-sourced or not.

The salient points of the court cases are as follows:

The courts rebutted the NTA's assessment for treating the remuneration earned by the foreign company from a combination of various services as "other income" under Article 8 Item 11 of the ITA. The courts opined that such treatment was incorrect and ruled that the remuneration received from various services should be regarded as "business profits", where such services qualify as core business operations of the foreign companies.

Further, the courts ruled that "business profits" should be treated as Taiwan-sourced income on the grounds that the services (as part of the core business operation of the service provider) were finally consumed in Taiwan. Thus, the foreign supplier was regarded to have operated its business within Taiwan.

In recent months, the Taiwan courts have delivered the same decision for similar tax cases, setting a disheartening trend. To date, the MOF has not made any announcements to address the courts' decision which appear to be in conflict with the Guideline. However, it can be anticipated that there will be more tax disputes in the future with regards to the definition of Taiwan-sourced income.

What next?

The above could mean an increased cost for local insurance companies when doing business with foreign companies. A few mitigation methods can be considered, such as relief through tax treaties, applying for a preferential tax rate of 3% under Article 25 of the ITA and proper transfer pricing to separate onshore and offshore remuneration.

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Thailand

Tax-accounting differences: New challenge for insurance businesses in light of the development of new accounting standards

Thailand is in the midst of converting its accounting standards to conform with International Financial Reporting Standards (IFRS). This conversion is now a hot issue in Thailand as it is a challenge for all companies and affects all areas of business.

As these differences are normally significant and yet temporary, it is very important for a company to understand the effects of both the accounting standards and the tax rules so that the information will be appropriately captured for calculating tax payment as well as for determining the deferred tax amount that is now required.

According to the announcement of the Federation of Accounting Professions (FAP), the new Thai Accounting Standards will be fully implemented from 2013. To achieve this goal, the FAP has divided the new standards into two groups and recently announced that the first series will be effective for the accounting period starting on/after 1 January 2011, while the remaining series must be in effect for the accounting period starting on/after 1 January 2013.

Although there has been a relaxation on the adoption of the new standards, such relaxation is not applicable to Publicly Accountable Enterprises, including insurance companies.

Book-tax differences

While the accounting standards have evolved significantly, the computation of taxable profit is still in accordance with provisions under the Revenue Code. If the tax rules are not revisited, it is certain that the adoption of the new accounting standards will create numerous differences between accounting and tax treatments. As these differences are normally significant and yet temporary, it is very important for a company to understand the effects of both the accounting standards and the tax rules so that the information will be appropriately captured for calculating tax payment as well as for determining the deferred tax amount that is now required.

To navigate the crucial early stages of the conversion, companies must have a framework that is both robust enough to drive projects, and flexible enough to interact with external stakeholders.

Reflecting the complexity of the task at hand, the following are the major temporary differences for the insurance industry that would be difficult, or sometimes impossible, to calculate the appropriate tax adjustments without a well-prepared methodology.

- Policy reserve and claim expense: This issue has been a major headache for the insurance industry in Thailand, especially for life insurance companies. Regardless of whether the policy reserve is calculated by actuarial or any risk-based model, the Revenue Department asserts that the reserve expense should still be viewed on an individual policy basis for the purposes of comparing whether or not it is over the given threshold. (For a life business, the upper limit of tax deduction available for policy reserve is 65% of net premiums received in the accounting period. For a non-life business, the upper limit is 40% of net premiums written in the accounting period.) In addition, only the incremental portion of the reserve or claim expense so calculated over such accumulated policy reserve claimed previously will be allowed as a deductible expense. The issue is further complicated due to the different deduction limits applicable for a life and non-life insurance policy. To date, it is still unclear which deduction limit should apply to the riders of life insurance policies that are similar in nature to those issued by non-life insurers, such as personal accident policies.

- Investment in securities: Although investments would be "mark-to-market" for accounting purposes, the historical cost basis is still applied for tax purposes. The Revenue Code currently allows only the investments that are classified as trading investments to be subject to the "lower of cost or market" valuation basis.

- Revenue recognition on investments: An effective yield method must be applied for accounting purposes. However, for tax purposes, without a change in the Revenue Code, premiums/discounts on debt securities are recognised only upon the maturity or disposal of the security while the interest income and fees earned from debt securities and loan arrangements must be recognised according to the contractual terms of the securities/ loan.

Engaging the Revenue Department

Since the book-tax differences arising are generally temporary differences, the burden and costs for the tax payers to keep two sets of information is disproportionate to any benefits that could possibly accrue. Several explanations and suggested ideas have been voiced to the Ministry of Finance and the Revenue Department to convince them that there should be a reformation of the Revenue Code in line with the new accounting standards. Together with the efforts from the insurance associations in Thailand, it seems that both Ministry of Finance as well as the Revenue Department now comprehend the urge to reconsider the tax rules, especially those pertaining to the policy reserve and claim expense.

The actual reformation will require some period of time. The Revenue Department will need to conduct a study and have a full understanding of the effect of the new accounting standards. In order for the amendment of the tax laws to take effect, it also must be subject to several approval procedures. Based on the new Director of the Revenue Department's intention to restructure the tax system in Thailand, this would be at least a

To navigate the crucial early stages of the conversion, companies must have a framework that is both robust enough to drive projects, and flexible enough to interact with external stakeholders.

two-year plan. Until there is official approval to revise the rules and regulations, it is strongly advised that the insurance industry be aware and be well-prepared for the effects that the upcoming changes in accounting standards will have on their tax calculations.

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